an incremental budget neutrality adjustment of 0.99857 for FY 2000 should be applied to the previous cumulative FY 1999 adjustment of 1.00294, yielding a cumulative adjustment of 1.00151 through FY 2000. For the Puerto Rico geographic adjustment factor, an incremental budget neutrality adjustment of 0.99910 for FY 2000 should be applied to the previous cumulative FY 1999 adjustment of 1.00233, yielding a cumulative adjustment of 1.00143 through FY 2000. We apply these new adjustments, then compare estimated aggregate Federal rate payments based on the FY 1999 DRG relative weights and the FY 2000 geographic adjustment factors to estimated aggregate Federal rate payments based on the FY 2000 DRG relative weights and the FY 2000 geographic adjustment factors. The incremental adjustment for DRG classifications and changes in relative weights would be 0.99991 nationally and for Puerto Rico. The cumulative adjustments for DRG classifications and changes in relative weights and for changes in the geographic adjustment factors through FY 2000 would be 1.00142 nationally, and 1.00134 for Puerto Rico. The following table summarizes the adjustment factors for each fiscal year:

BUDGET NEUTRALITY ADJUSTMENT FOR DRG RECLASSIFICATIONS AND RECALIBRATION AND THE GEOGRAPHIC ADJUSTMENT FACTORS

Fiscal year	National				Puerto Rico			
	Incremental adjustment			Cumulative	Incremental adjustment			Cumulative
	Geographic adjustment factor	DRG reclassifications and recalibration	Combined		Geographic adjustment factor	DRG reclassifications and recalibration	Combined	
1992	....	....	....	1.00000	....	....	....	....
1993	....	....	0.99800	0.99800	....	....	....	....
1994	....	....	1.00531	1.00330	....	....	....	....
1995	....	....	0.99980	1.00310	....	....	....	....
1996	....	....	0.99940	1.00250	....	....	....	....
1997	....	....	0.99873	1.00123	....	....	....	....
1998	....	....	0.99892	1.00015	....	....	....	1.00000
1999	0.99944	1.00335	1.00279	1.00294	0.99898	1.00335	1.00233	1.00233
2000	0.99857	0.99991	0.99848	1.00142	0.99910	0.99991	0.99901	1.00134

The methodology used to determine the recalibration and geographic (DRG/GAF) budget neutrality adjustment factor is similar to that used in establishing budget neutrality adjustments under the prospective payment system for operating costs. One difference is that, under the operating prospective payment system, the budget neutrality adjustments for the effect of geographic reclassifications are determined separately from the effects of other changes in the hospital wage index and the DRG relative weights. Under the capital prospective payment system, there is a single DRG/GAF budget neutrality adjustment factor (the national rate and the Puerto Rico rate are determined separately) for changes in the geographic adjustment factor (including geographic reclassification) and the DRG relative weights. In addition, there is no adjustment for the effects that geographic reclassification has on the other payment parameters, such as the payments for serving low-income patients or the large urban addon payments.

In addition to computing the DRG/GAF budget neutrality adjustment factor, we used the model to simulate total payments under the prospective payment system.

Additional payments under the exceptions process are accounted for through a reduction in the Federal and hospital-specific rates. Therefore, we used the model to calculate the exceptions reduction factor. This exceptions reduction factor ensures that aggregate payments under the capital prospective payment system, including exceptions payments, are projected to equal the aggregate payments that would have been made under the capital prospective payment system without an exceptions process. Since changes in the level of the payment rates change the level of payments under the exceptions process, the exceptions reduction factor must be determined through iteration.

In the August 30, 1991 final rule (56 FR 43517), we indicated that we would publish each year the estimated payment factors generated by the model to determine payments for the next 5 years. The table below provides the actual factors for FYs 1992 through 1999, the final factors for FY 2000, and the estimated factors that would be applicable through FY 2004. We caution that these are estimates for FYs 2001 and later, and are subject to revisions resulting from continued methodological refinements, receipt of additional data, and changes in payment policy. We note that in making these projections, we have assumed that the cumulative national DRG/GAF budget neutrality adjustment factor will remain at 1.00142 (1.00134 for Puerto Rico) for FY 2000 and later because we do not have sufficient information to estimate the change that will occur in the factor for years after FY 2000.

The projections are as follows:

Fiscal year	Update factor	Exceptions reduction factor	Budget neutrality factor	DRG/GAF adjustment factor [1]	Outlier adjustment factor	Federal rate adjustment	Federal rate (after outlier) reduction)
1992	N/A	0.9813	0.9602	....	.9497	....	415.59
1993	6.07	.9756	.9162	.9980	.9496	....	417.29
1994	3.04	.9485	.8947	1.0053	.9454	[2] .9260	378.34
1995	3.44	.9734	.8432	.9998	.9414	....	376.83
1996	1.20	.9849	N/A	.9994	.9536	[3] .9972	461.96
1997	0.70	.9358	N/A	.9987	.9481	....	438.92
1998	0.90	.9659	N/A	.9989	.9382	[4] .8222	371.51
1999	0.10	.9783	N/A	1.0028	.9392	....	378.10
2000	0.30	.9730	N/A	.9985	.9402	....	377.03
2001	0.50	.9636	N/A	[5] 1.0000	[5] .9402	....	375.26
2002	0.50	[6] 1.0000	N/A	1.0000	.9402	....	391.38
2003	0.50	[6] 1.0000	N/A	1.0000	.9402	[4] 1.0255	403.38

Fiscal year	Update factor	Exceptions reduction factor	Budget neutrality factor	DRG/GAF adjustment factor [1]	Outlier adjustment factor	Federal rate adjustment	Federal rate (after outlier) reduction)
2004	0.50	[6] 1.0000	N/A	1.0000	.9402	....	405.40

[1] Note: The incremental change over the previous year.
[2] Note: OBRA 1993 adjustment.
[3] Note: Adjustment for change in the transfer policy.
[4] Note: Balanced Budget Act of 1997 adjustment.
[5] Note: Future adjustments are, for purposes of this projection, assumed to remain at the same level.
[6] Note: We are unable to estimate exceptions payments for the year under the special exceptions provision (§ 412.348(g) of the regulations) because the regular exceptions provision (§ 412.348(e)) expires.

Appendix C: Recommendation of Update Factors for Operating Cost Rates of Payment for Inpatient Hospital Services

I. Background

Several provisions of the Act address the setting of update factors for inpatient services furnished in FY 2000 by hospitals subject to the prospective payment system and those excluded from the prospective payment system. Section 1886(b)(3)(B)(i)(XV) of the Act sets the FY 2000 percentage increase in the operating cost standardized amounts equal to the rate of increase in the hospital market basket minus 1.8 percent for prospective payment hospitals in all areas. Section 1886(b)(3)(B)(iv) of the Act sets the FY 2000 percentage increase in the hospital-specific rates applicable to sole community and Medicare-dependent, small rural hospitals equal to the rate set forth in section 1886(b)(3)(B)(i) of the Act, that is, the same update factor as all other hospitals subject to the prospective payment system, or the rate of increase in the market basket minus 1.8 percentage points. Under section 1886(b)(3)(B)(ii) of the Act, the FY 2000 percentage increase in the rate of increase limits for hospitals excluded from the prospective payment system ranges from the percentage increase in the excluded hospital market basket to 0 percent, depending on the hospital's costs in relation to its limit for the most recent cost reporting period for which information is available.

In accordance with section 1886(d)(3)(A) of the Act, we are updating the standardized amounts, the hospital-specific rates, and the rate-of-increase limits for hospitals excluded from the prospective payment system as provided in section 1886(b)(3)(B) of the Act. Based on the second quarter 1999 forecast of the FY 2000 market basket increase of 2.9 percent for hospitals subject to the prospective payment system, the updates in the standardized amounts are 1.1 percent for hospitals in both large urban and other areas. The update in the hospital-specific rate applicable to sole community and Medicare-dependent, small rural hospitals is also 1.1 percent. The update for hospitals excluded from the prospective payment system can be as high as the percentage increase in the excluded hospital market basket (currently estimated at 2.9 percent) or as low as zero, depending on the hospital's costs in relation to its rate-of-increase limit. (See Section V of the Addendum to this final rule.)

Section 1886(e)(4) of the Act requires that the Secretary, taking into consideration the recommendations of the Medicare Payment Advisory Commission (MedPAC), recommend update factors for each fiscal year that take into account the amounts necessary for the efficient and effective delivery of medically appropriate and necessary care of high quality. In its March 1, 1999 report, MedPAC stated that the legislated update of market basket increase minus 1.8 percentage points would provide a reasonable level of payment to hospitals. Although MedPAC suggests that a somewhat lower update could be justified in light of changes in the utilization and provision of hospital inpatient care, the Commission does not believe it is necessary to recommend a lower update for FY 2000. MedPAC did not make a separate recommendation for the hospital-specific rates applicable to sole community and Medicare-dependent, small rural hospitals.

Under section 1886(e)(5) of the Act, we are required to publish the update factors recommended under section 1886(e)(4) of the Act. Accordingly, we published the FY 2000 update factors recommended by the Secretary as Appendix D of the May 7, 1999 proposed rule (64 FR 24852).

Under section 1886(e)(4) of the Act, we recommended that an appropriate update factor for the standardized amounts was 0.0 percentage points for hospitals located in large urban and other areas. We also recommended an update of 0.0 percentage points to the hospital-specific rate for sole community hospitals and Medicare-dependent, small rural hospitals. These figures are consistent with the President's FY 2000 budget recommendations. We stated that we believe our recommended update factors would ensure that Medicare acts as a prudent purchaser and provide incentives to hospitals for increased efficiency, thereby contributing to the solvency of the Medicare Part A Trust Fund.

In the proposed rule, we recommended that hospitals excluded from the prospective payment system receive an update of between 0 and 2.6 percentage points. The recommended update for excluded hospitals and units was equal to the increase in the excluded hospital operating market basket less a percentage between 0 and 2.5 percentage points, or 0 percentage points, depending on the hospital's or unit's costs in relation to its rate-of-increase limit. For the proposed rule, the market basket rate of increase was forecast at 2.6 percent. This recommendation was consistent with the President's FY 2000 budget, although we noted that the market basket rate of increase was forecast at 2.7 percent when the budget was submitted.

II. Secretary's Final Recommendations for Updating the Prospective Payment System Standardized Amounts

We received seven comments concerning our proposed recommendations, two of which commented directly on the update recommendation. Our final recommendations for the operating update for both prospective and excluded hospitals do not differ from the proposed. However, the second quarter forecast of the market basket percentage increase is 2.9 for prospective payment hospitals (up from 2.7 estimated in the proposed rule) and 2.9 for excluded hospitals and units (up from 2.6 estimated in the proposed rule).

Comment: Several commenters expressed support for our proposal to update hospital payment rates on October 1, 1999, rather than delaying the update because of concerns about "Year 2000" (Y2K) systems issues. One commenter, while acknowledging that we are required to use the factors set in current law to update payment rates, expressed concern that an update to the rates less than the full market basket rate of increase is inadequate, forcing hospitals to forego technological advances that may improve quality and patient outcomes. Another commenter believes that the proposed updates would place more financial hardship on hospitals, in particular teaching hospitals, by freezing or reducing payment rates.

Response: We appreciate the support from commenters. As the one commenter noted, we are required by section 1886(b)(3) of the Act, as amended by the Balanced Budget Act of 1997 (BBA), to update rates for FY 2000 by the estimated increase in the hospital market basket minus 1.8 percentage points. Our latest available data show that hospital costs per case are continuing to decline while payments per case are increasing, resulting in high average Medicare profit margins across all hospitals. Therefore, we believe that the update to payment rates specified by law for FY 2000 is sufficient to allow hospitals to continue providing Medicare beneficiaries with efficient care of high quality. We will continue to monitor the financial performance of hospitals as newer data become available and will adjust our future update recommendations to Congress as appropriate.

Comment: MedPAC stated that while HCFA's proposed update recommendation of zero percentage points is within the range that MedPAC adopted in its own recommendation, the Commission believes that the update specified in law is appropriate because the effects of the BBA are not yet fully evident. Reducing payments below the level prescribed by law would not be prudent, at least for FY 2000. MedPAC further stated that it will monitor the financial performance of hospitals under BBA during the coming year.

Response: As we stated in the proposed rule, we believe that our recommendation (an update of zero percentage points) is an appropriate response to current trends in health care delivery, including the recent decreases in the use of hospital inpatient services and the corresponding increase in the use of hospital outpatient and postacute care services. Furthermore, as a prudent purchaser of health care for Medicare beneficiaries, we believe it is important that we maintain incentives to hospitals to provide high quality care efficiently. Like MedPAC, we, too, will continue to monitor the financial performance of hospitals and adjust future update recommendations as appropriate.

III. Secretary's Final Recommendation for Updating the Rate-of-Increase Limits for Excluded Hospitals

We received one comment concerning our proposed recommendation for updating the rate-of-increase limits for excluded hospitals.

Comment: MedPAC recommended adding 0.4 percentage points to the market basket forecast before applying the update formula to account for technical improvements that hospitals must make related to Y2K-related computer problems. MedPAC believes Y2K-related computer malfunctions could potentially compromise patient care by interrupting service continuity, thereby creating substantial liability exposure for hospitals. Therefore, HCFA should increase the market basket forecast to account for the additional costs hospitals will incur in making computer system improvements to avoid Y2K problems.

Response: Our final recommendation is that hospitals and hospital units excluded from the prospective payment system receive an update using a market basket increase estimate of 2.9 percentage points. This update is consistent with the updates provided to the prospective payment hospitals. We note that under our update framework for excluded hospitals and units, the analysis indicates identical findings to those for prospective payment system hospitals regarding changes in productivity, scientific and technological advances, practice patterns, and case-mix for FY 2000. We believe these updates will ensure that Medicare acts as a prudent purchaser and will provide incentives to hospitals for increased efficiency. Thus, using the statutory target amount update formula, the update factor for an excluded hospital or unit will be between 0.4 percent and 2.9 percent, or 0.

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